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An Overview of Private Placements and Raising Capital

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Entrepreneurs and their companies find financing from many sources, including banks, friends and family, and venture capital funds, as well as institutional, private equity, and wealthy individual investors. Financing can be structured as debt or equity (preferred or common stock) or a combination. With the lending environment still challenging, many companies are raising capital through private placements and private equity investments. This article will provide an overview of some of the legal and business considerations of raising capital, primarily focusing on the federal laws and regulations applicable to the offering and sale of securities. While this article uses terms that apply to corporations, the same issues and concepts apply regardless of the type of issuer selling its securities (limited liability company, partnership, etc.).

Preparing for an Offering

In order to present itself to investors in the best possible light, a company should address a number of important issues prior to conducting an offering. Such preparation is not only necessary, but will enhance the company's credibility with sophisticated investors who expect the company to demonstrate that it is ready for investment partners. Among the issues that should be addressed are the following: estimating the size of the offering based upon the company's anticipated need for funds over a certain period of time; identifying potential sources of financing; deciding whether to utilize a selling agent and whether the offering will be structured as a minimum-maximum offering (in which case, no securities are sold until at least the minimum is sold); selecting the type of security to be offered; and determining the rights that investors will have, such as representation on the company's board of directors. Accepting investor funds is the beginning of an ongoing relationship with the investors, and the company must be prepared to meet reasonable investor expectations.

Many investors will expect preferred stock with certain preferences over the common stock issued to the founders of the company, and they may expect certain participation rights with respect to future rounds of financing. Investors may decide whether to invest or not based upon the type of security offered and whether the opportunity presented meets investor expectations. The offering must reflect the risk associated with the company and should be structured to meet the expectations of investors relating to return on investment, preferences, and the like. Companies should obtain legal advice to ensure that the company's articles, bylaws, and other organizational documents properly authorize and describe the securities to be issued, the ongoing rights of the investors, and any rights investors may have to liquidate their investment. As to the offering itself, the company must ensure that it does not violate the applicable securities laws and regulations. If a company sells securities in violation of the securities laws, then the sales are subject to rescission by the investors. Companies, and their officers and directors, can be subject to civil and criminal penalties as well.

Application of the Securities Laws

Sales of securities (whether debt or equity) either must be registered or exempt from registration under the Securities Act of 1933 and applicable state securities laws. The exemptions are designed to allow sales that are limited in dollar amount or number of investors without requiring a registration. It is important to understand

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the various exemptions available under the federal and state securities laws and how they relate to one another in order to avoid unintentional violations. Each state where an investor resides (or where an investment entity is organized) must be checked to determine if a state exemption is available. There are a number of federal exemptions, including Securities and Exchange Commission ("SEC") Regulation A and Section 4(6), but the primary exemption upon which companies most often rely is SEC Regulation D (Rules 501 through 506).

A. Regulation D. Rules 501-503 of Regulation D establish certain conditions for the exemptions, and Rules 504-506 are the three exemptions under Regulation D. Each of these exemptions have different requirements and vary with regard to: (i) the maximum dollar amount that may be sold in the offering; (ii) the maximum number of investors to whom the securities may be sold; (iii) the information required to be provided to potential investors; and (iv) the types of investors to whom the securities may be sold. The following is only a summary of these exemptions, as there are detailed requirements beyond the scope of this article.

1. Definition of "Accredited Investor." The term "accredited investor" is a key concept under Regulation D. The most important categories of accredited investors include: (i) directors, executive officers, and general partners of the issuer of the securities; (ii) any natural person whose individual net worth (or joint net worth with that person's spouse) at the time of purchase exceeds $1,000,000 (since 2010, an investor's primary residence cannot be counted for purposes of the net worth calculation); (iii) any natural person who had an individual income in excess of $200,000 (or joint income with that person's spouse in excess of $300,000) in each of the two most recent years and who reasonably expects to meet these income tests in the current year; (iv) any corporation, not formed for the purpose of acquiring the securities offered, with total assets in excess of $5,000,000; and (v) any entity in which all of the equity owners are accredited investors. There are additional categories of accredited investors, including certain institutional investors and certain organizations and trusts with total assets in excess of $5,000,000. The company is required to determine whether a subscriber is an "accredited investor." This typically is done through the use of a questionnaire seeking information that will establish the facts and representations upon which the determination is based.

2. Rule 504 – Offerings of Up to $1,000,000. Rule 504 allows the sale of securities in an aggregate maximum dollar amount of $1,000,000. Rule 504 may be used with an unlimited number of investors; no distinction is made between accredited and non-accredited investors under Rule 504.

3. Rule 505 – Offerings of Up to $5,000,000. Rule 505 permits aggregate sales of up to $5,000,000. Under Rule 505, sales may be made to up to 35 purchasers who are not accredited investors and to an unlimited number of accredited investors.

4. Rule 506 – Offerings Unlimited As to Dollar Amount. Rule 506 does not impose a limit on the dollar amount of an offering. Sales may be made to up to 35 purchasers who are not accredited investors and to an unlimited number of accredited investors. Any purchaser who is not an accredited investor must be "qualified." This "qualification" is based on the company's "reasonable belief" that immediately prior to the sale such purchaser (either alone or with a purchaser representative) has such knowledge and experience in financial and business matters that he or she is able to evaluate the merits and risks of the prospective investment. The usual procedure for establishing such reasonable belief is to incorporate in a subscription agreement a representation by potential purchasers that they have such knowledge and experience. Federal law provides that offerings made under Rule 506 are exempt from regulation by the states, except for notice and filing fee requirements.

5. Information Required to be Furnished to Investors – The Private Placement Memorandum. If sales are made pursuant to Rule 504, or only to accredited investors under Rule 505 or 506, then there are no specific requirements with regard to information to be furnished to investors. Use of a thorough Private Placement Memorandum, however, is always prudent. Even if no disclosure document is technically required, offers and sales made under these exemptions are still subject to the antifraud provisions of the securities laws. To provide investors with the opportunity to make an informed decision, and to

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document the adequacy of the information provided by the company, thorough disclosure is always beneficial. The primary offering document is typically called a "Private Placement Memorandum" and includes the following: a summary of the terms of the offering; a description of the risk factors related to the investment and the company's business; a description of the company's intended use of the proceeds from the offering; a description of the company's capitalization before and after the offering; a description of the company's business, including its products and services, markets, and competition; the identification and business background of management; a listing of the ownership interests for the company's officers, directors, and other principal owners; a description of any "related party" transactions; a description of the securities being offered, including any restrictions on the transferability of the securities; and the intended plan of distribution, including identity of any underwriter or selling agent and such organization's compensation for its services in connection with the offering.

6. Financial Statement Disclosure. In addition to the above business disclosures, financial statement disclosure may be required. For offerings up to $2,000,000, Regulation D requires that the company provide financial statements to any non-accredited investor consisting of a balance sheet as of the end of the most recent fiscal year and statements of income, cash flow, and shareholders' equity for each of the two most recent fiscal years (or for such shorter time as the company has been in business). If the company's fiscal year ended more than 120 days prior to the commencement of the offering, a balance sheet as of the end of the most recent interim period and income statements for the period ending on the date of the balance sheet and the comparable period of the preceding fiscal year must be provided. If a company cannot obtain audited statements without unreasonable effort or expense, then only the balance sheet, which must be dated within 120 days before the start of the offering, must be audited. For offerings between $2,000,000 and $7,500,000, all of the financial statements must be audited. For offerings over $7,500,000, the audited financial statements must contain balance sheets for the last two years and income statements for the last three fiscal years.

7. Limitations on Manner of Offering. Rule 505 and 506 of Regulation D do not allow general solicitation or advertising. General solicitation or advertising includes any advertisement, article, notice, or other communication published in any newspaper, magazine, or similar media or broadcast over television or radio and any seminar or meeting whose attendees have been invited by any such general solicitation or advertising. Although SEC Rule 504 does not prohibit general solicitation, many state exemptions prohibit general solicitation regardless of the size of the offering. For example, Minnesota's companion exemption to Regulation D, Minn. Stat. § 80A.46(14), prohibits general solicitation or advertising without regard to the size of the offering. Companies are responsible for the acts of their agents as well, so companies should obtain advice about using a selling agent. There are licensed brokers/dealers that assist with private offerings, as well as unlicensed "finders." The law involving finders is evolving, and Minnesota now requires agents who are not licensed broker/dealers and who are providing introductions as part of an offering to make a filing about their role in an offering with the Department of Commerce. Companies should be particularly careful about using an unlicensed selling agent, as the scope of their services and compensation requires careful legal analysis.

B. Form D Filing with the SEC Regulation D requires that a company file a Notice of Sales on Form D no later than 15 days following the first sale of its securities. The Form D is now required to be filed electronically, which necessitates that the company obtain filing codes for the SEC's electronic filing system, EDGAR. Many states require notice filings as well.

Conclusion

Although this article provides an overview of major issues relevant to a private offering, the securities laws are complex and require careful planning and attention. There are other issues not addressed herein (such as the limitations on resale that apply to restricted securities and the risk of integration with other offerings). Companies are encouraged to seek advice early, as proper planning will not only avoid the severe penalties associated with securities violations, but also will ensure that a company is positioned to raise capital when it needs to do so without having complications arising from prior sales.